Fall 2019 China Dashboard Net Assessment

The Story So Far

In the decades following China's 1978 decision to reform and open, its growth was driven by demographics and structural adjustment – letting market logic reshape the economic landscape. But in recent years, as the easier phase of development gave way to middle-income challenges, Beijing has attempted to reassert control over investment and markets. This was not the first choice. President Xi Jinping's inaugural 2013 Third Plenum economic plan – while still couched in Communist Party nomenclature – was distinctly geared toward a decisive role for markets. Implementation of those goals, rather than aspiration, has been most lacking. By tracking China's own 2013 objectives across 10 economic domains, The China Dashboard seeks to inform public debate with objective data on just how close to or far from those aspirations China is trending.

Gauging China's policy progress objectively is essential for understanding what sort of economy – and polity – China will have domestically in the future, and just as critically what role China will play in the international community. The current tensions between China and the United States represent the sort of situation we previously anticipated at the conception of the Dashboard project and seek to temper through the dissemination of respected data indicators and interpretation. For this reason, we eschew normative advice or prognostication about the future of the Chinese economy, though we do point out clear conundrums in the outlook.

Bottom Line

Anticipation is building once again toward a U.S.-China trade agreement that would pause tariff escalation or even partially reverse it, and potentially include a range of commitments covering agricultural purchases, market access, currency, and intellectual property protections. Simultaneously, there are signs of emphasis from Beijing on reform policy, showing some willingness to engage on sensitive policy issues where reforms have been largely stalled for some time. Should reform fanfare amid ongoing trade negotiations be considered a harbinger of change or just more of the same?

We were early to observe that U.S.-China relations as we knew them were changing fundamentally. We did not think it did any good to pretend that we were just going through a rough patch: engagement had been justified and sustained by signs of China's policy convergence with market economy norms. The critical mass of evidence that this was still the case had eroded, and without that divergence was inevitable.

Trade tensions are weighing on China's economy, but headwinds are blowing more from the consequences of domestic policy imprudence in the name of growth, which now contribute to faltering performance and future challenges. The silver lining of near-term pessimism about the costs of U.S.-China tensions and a broader U.S.-China decoupling is that these conditions may hasten a change in course for Beijing, resulting in bolder reforms. Indeed, some U.S. policymakers are hoping for this narrative playing out.

With its tradition of reform over the past 40 years, Beijing is more likely than not to *ultimately* accept the necessity of reverting back to marketization. However, the current holdup is that a significant degree of political reform must be part of the mix, if the economic reforms are going to be meaningful. Given the malaise that has settled over expectations for U.S.-China relations in the Trump-Xi era, this makes us cautious optimists, but with a difficult course to run. The current bout of Chinese statism is precipitating internal economic trouble, and that will recycle reforms to the fore, re-opening the door to engagement. But when?

Some developments getting attention might qualify as "green shoots" of renewed reform efforts even if the aggregate picture is murky:

- The "double-hundred actions" campaign, launched in August 2018, has focused on implementing mixed ownership and corporate governance reform in more than 400 central and local pilot state-owned enterprises (SOEs) by 2020. If faithfully implemented, this campaign would signal intent to reduce state control in pilot firms and discipline state influence over their commercial decisions.

- In a September joint report with the World Bank, the State Council's Development Research Center acknowledged pervasive market distortions as a result of existing industrial policies and recommended market-oriented reforms, based on workshops across multiple key government agencies suggesting broad endorsement of the report's findings.

- Regulators announced concrete 2020 timetables for lifting foreign equity caps on futures, securities, insurance, and banking companies. Alongside this we see a revised foreign insurance company regulation and a new foreign bank regulation that relax operating restrictions.

- Following the new Foreign Investment Law's passage in March (effective in January) and a reduction of entries on the negative list for foreign investment, authorities scrapped quotas on certain inbound foreign investments and committed to lifting foreign equity caps in additional sectors. New implementing measures for the law are now being put to the test.

- An October State Council issuance pledges to ensure "all types of business entities have equal access" to key inputs including credit, land, and licenses and "enjoy state support policies equally." The rule stipulates that no level of government should "force foreign investors and companies to transfer technology, explicitly or implicitly."

- Officials repeatedly echoed commitments to improve the environment for foreign investors and lift the quality of economic growth. These commitments are not new, concrete, or inherently credible, but they have become more frequent in 2019 amid ongoing trade talks and rising risks to the domestic economy.

    - Premier Li Keqiang held a televised meeting with U.S. executives confirming the direction of China's reform policies regarding foreign investors and has reiterated in State Council meetings that China will continue to open up to foreign investment, promote ease of investing, protect foreign investor interests, and strengthen investment promotion on the local level.

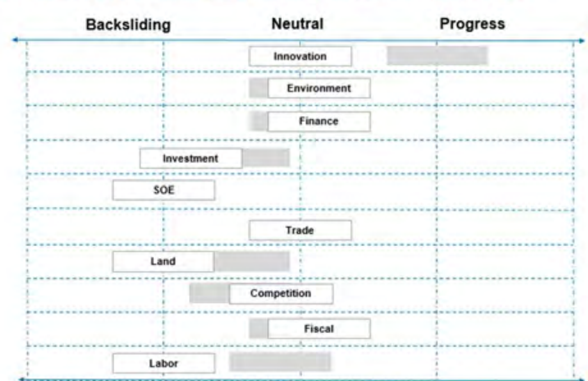
    - Central bank governor Yi Gang commented that China should "cherish the scope of normal monetary policy" while other global central banks were easing to cement its position as "the highlight of the global economy and one the market should admire," suggesting restraint in stimulating the slowing economy to attract capital inflows.

    - Vice Commerce Minister Wang Shouwen said in October that China will eliminate foreign investment restrictions in financial services and many other sectors, and that China would "neither explicitly nor implicitly" force foreign entities to transfer technologies to Chinese firms.

- Former finance minister Lou Jiwei acknowledged the need for China to have more "mature" market rules in financial opening and that "to attract mature institutional investors from overseas, we first need to improve on supervision methods, rules, and procedures." The Party's Fourth Plenum, held in November, recognized the 2013 economic reform program as a milestone on par with the historic 1978 Third Plenum and committed to improvement on a number of competition-related issues including the foreign investment negative list, market entry, competition policy, anti-monopoly review, and intellectual property (IP) and business secret protections. However, the Party failed to acknowledge shortcomings in reform implementation since 2013 and unapologetically insisted that SOEs will not retreat from the economy, suggesting a conservative stance going forward on SOE reform.

From day one, our Dashboard indicators were designed to test these commitments. In the main, we find reform in five of ten policy areas has regressed since the 2013 Third Plenum, two areas are stalled, and three areas have improved slightly. In the aggregate neither the outcomes we see at present nor the specifics of the green shoots described above are proof of a change of season – yet. However, actions that would start to bend our indicators in the right direction may be within reach, and the tone and frankness of many policy signals are helpful. If the countervailing indications that are just as readily found – some of them tit-for-tat in response to American moves, some of them, like further enshrinement of the role of Party committees in corporate management, more structural reforms – can be pruned from the policy tree, then the prognosis for China's engagement with the advanced market economies will brighten.

Fall 2019 Net Assessment: Quarterly Movement in 10 Areas



Dashboard Indicators

Policymakers made much to do about **State-Owned Enterprise** (SOE) reform achievements in 1H2019, but our indicators show policies since 2013 have not reduced state control of SOEs or their role in the economy. According to the SOE Reform Small Leading Group (SLG), one-quarter of pilot SOEs have diversified their shareholding structure, one-third have attracted private capital into group companies, and more than half have attracted private capital into their subsidiaries. Together, pilot SOEs have completed around 30% of reform tasks and attracted 538 billion yuan ($77 billion) in private capital.

This seemingly positive progress is inconsistent with our primary indicator: the campaign included 61 listed companies, but our indicator picked up ownership changes only in a few SOEs, with no meaningful change in SOE presence in the economy. One explanation is that the pilots did not sell large enough stakes, keeping the state as controlling shareholder. If that is the case, the campaign is not successfully reducing state control over pilot enterprises but rather bringing more private capital under state control.

Efforts so far to professionalize SOE boards are likely inadequate to bind SOEs to market principles as they fail to address one fundamental problem: SOE leaders are still government officials subject to state evaluation; therefore, they are likely to prioritize political objectives over commercial ones compared with private firm leaders. Meanwhile, SOE megamergers are proceeding unchecked, as demonstrated by the late October approvals for combining China's two shipbuilding giants.

Market opening saw the most policy attention so far in 2019, yet our indicator of **Cross-border Investment** reform suggests backsliding. Cross-border capital flows continued declining as a proportion of China's economy in 2Q2019, reaching a record low level of 4.26% of GDP. Both inflows and outflows trended lower relative to the size of the economy this quarter, highlighting the limits to implementing liberalization promises so far, and the urgency of doing so. The growing political divide between China and the rest of the world may become a significant influence on those flows over time, particularly if market-driven investors start to see negative political costs attached to both direct investments in China and portfolio investments in Chinese securities.

In other areas, Beijing has advanced reforms that contributed to slowing economic growth in the short term, causing declines in some indicators.

In **Financial System** reform, for example, the allowance of bank failure by regulators in May, forcing some depositors to take losses, marks a new era. In addition, incremental steps are being taken to advance interest rate reform, which should unify market and policy rates so that borrowers and lenders respond to more market-based price signals. However, despite these credible and positive intentions, our quarterly incremental capital output ratio reached its highest level this quarter since at least 2011, indicating deteriorating efficiency within China's financial system. China's slowing growth, not a resurgence in capital growth, drove the Quarterly Incremental Capital Output Ratio's rise: in the first half of 2019, capital formation accounted for its smallest-ever share of real economic growth.

The slowing economy is also affecting China's households, which face not only fewer employment opportunities and lower income growth but also higher costs of living related to healthcare, food prices, and housing, as well as tariff hikes. Wages for urban and migrant workers fell compared to total economic growth, with migrant wages growing 33% slower than GDP. New job creation registered the biggest decline since mid-2015, with 220,000 fewer net jobs created over the past four quarters than in the previous year. Companies appear hesitant to add to payroll amid the current slowdown and future uncertainties. So far this year, Beijing has sought to boost income growth by cutting taxes and increasing lending to smaller, private companies so that they increase employment and wages, but these indirect measures have had little identifiable impact and have only chipped away at the national tax base.

We found slight improvement in **Competition** policy reform, though our net assessment is still negative. The government reviewed 32 foreign-involved mergers in 2Q2019, fewer than domestic mergers (33) for the first quarter on record. The proportion of foreign-involved mergers reviewed in the second quarter (23%) also decreased from 27% in 1Q2019, even though foreign-involved mergers are still reviewed three times more often than the 8% of domestic mergers reviewed. Chinese courts also published many more competition-related cases this quarter, increasing the proportion of cases published from 5% of total cases handled by the courts in 1Q2019 to 15% in 2Q2019—though they simultaneously removed hundreds of other court cases.

View from Abroad

What concrete moves on Beijing's part would demonstrate more definitively that reform was again a driving force? There are many candidates. A meaningful set of state enterprises not in truly essential public good industries could be privatized, both to pay down subnational government debt and to promote the centrality of the private sector. Rather than rolling up already large state oligopolies into even larger national champions, regulators could embrace pro-competitive policies to break up or prevent mergers by major domestic firms. Beyond the piecemeal opening to foreign investment, antiquated joint venturing requirements could be eliminated wholesale on an expedited schedule. Beijing could formally and publicly classify SOEs into commercial and noncommercial categories, as envisioned in President Xi's 2015 Guiding

Opinions, and to allow commercial firms to compete fairly with other market players.

These acid tests of systemic reforms could underpin a sustainable warming trend toward China in economic circles abroad. By contrast, politically conceived target campaigns for growing Chinese imports by a certain percentage by a certain year are more likely – both because they suit the state-planning mind-set prominent in Beijing today and because they are the managed trade approach at the heart of key Washington trade demands of China. A handful of American constituencies – mostly commodity agricultural producers and fossil fuel exporters – could be bolstered by this focus, though they were just as well or better served by market trends that predated the trade war. Other U.S. industries will not benefit from this approach, while most other market economies will view these commitments as opposing World Trade Organization principles and diverting business from their companies. A "Phase 2" of a U.S.-China agreement would focus on structural reform issues like forced technology transfer and industrial subsidies though political flashpoints such as escalating Hong Kong protests may diminish the probability of concluding either phase this year.

As the prospect of truce in the U.S.-China standoff as we have known it in the Trump years looms, this difference in essence – structural move to market orientation or just a package to reduce the U.S. trade deficit no matter how we get there or some combination – will determine the tone of the foreign conversation for the coming months. There are green shoots in multilateral alignment among liked-minded market economies on how to respond to shared concerns about the impact of China's system worldwide as well. On investment screening, export controls, critical infrastructure resilience, data protection, and other fronts, there are some meaningful moves toward commonality among the United States, Europe, Japan, and other developed economies. But whether this basic shared interest can flourish and grow into a true constructive coalition or rather wither under the weight of differences on ambition and continued unilateralism is being put to the test.